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EDITED TRANSCRIPT

L.TO - Q1 2018 Loblaw Companies Ltd Earnings Call

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OVERVIEW:

Co. reported 1Q18 adjusted net earnings available to common shareholders of CAD361m and adjusted EPS of CAD0.94.



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CORPORATE PARTICIPANTS

Darren G. Myers *Loblaw Companies Limited - CFO & Member of Management Board*

Galen G. Weston *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Roy MacDonald

Sarah R. Davis *Loblaw Companies Limited - President & Member of Management Board*

CONFERENCE CALL PARTICIPANTS

Christopher Li *Macquarie Research - Research Analyst*

Irene Ora Nattel *RBC Capital Markets, LLC, Research Division - MD of Global Equity Research*

James Durran *Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst*

Keith Howlett *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

Mark Robert Petrie *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

Michael Van Aelst *TD Securities Equity Research - Research Analyst*

Patricia A. Baker *Scotiabank Global Banking and Markets, Research Division - Analyst*

Peter Sklar *BMO Capital Markets Equity Research - Analyst*

Vishal Shreedhar *National Bank Financial, Inc., Research Division - Analyst*

PRESENTATION

Operator

Good morning. My name is Tiffany, and I will be your conference operator today. At this time, I would like to welcome everyone to the Loblaw Companies Limited First Quarter Results Conference Call. (Operator Instructions) Roy MacDonald, VP Investor Relations, you may begin your conference.

Roy MacDonald

Great. Thanks very much, Tiffany. Good morning, everybody. Welcome to the Loblaw Companies Limited First Quarter 2018 Results Conference Call. This morning, I'm joined by Galen Weston, our Chairman and CEO; Darren Myers, our CFO; and by Sarah Davis, our President.

Before we begin today's call, I want to remind you that today's discussion will include forward-looking statements, such as the company's beliefs and expectations regarding certain aspects of its financial performance in 2018 and in future years. These statements are based on certain assumptions and reflect management's current expectations and are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from our expectations. These risks and uncertainties are discussed in the company's materials filed with the Canadian regulators.

Any forward-looking statements speak only as of the date they are made. The company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, other than what's required by law.

Also, certain non-GAAP financial measures may be discussed or referred to today. Please refer to our annual report and other materials filed with the Canadian securities regulators for a reconciliation of each of these measures to the most directly comparable GAAP financial measure.

I will now turn the call over to Darren.



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Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Thank you, Roy, and good morning, everybody. We delivered solid financial results in the first quarter. As expected, 2018 began with the company facing into significant industry headwinds. We saw the full impact of the changes to minimum wage rates in the quarter and a portion of the incremental health care reform, with the balance beginning in the second quarter.

Overall, these impacts were in line with our expectations. Against this backdrop, we are pleased with our first quarter results, supported by our continued focus on stable trading and driving process and efficiency improvements.

In the first quarter, on an adjusted consolidated basis and normalized for the disposition of the gas bar business, our revenue grew 3.1%. We delivered growth in EBITDA of 3.3%, net earnings growth of 1.4% and fully diluted earnings per share growth of 6.7%. We continue to drive positive same-store sales with growth of 1.9% in food retail and 3.7% in drug retail. Drug retail same-store sales growth was supported by Front Store growth of 3.8% and pharmacy growth of 3.5%.

Looking at food retail. Our internal inflation was marginally lower than CPI. Against an intense competitive backdrop, we were pleased with our performance as we delivered growth in tonnage, traffic and average basket. At Shoppers, we saw continued strength across categories, led by HBA, cosmetic and over-the-counter categories. Pharmacy grew in the quarter as count growth outpaced declines in the average value of prescriptions.

Retail gross margin was 29%, an improvement of 100 basis points from the same quarter last year. Our retail gross margin declined 20 basis points year-over-year after excluding a favorable 70 basis points from the impact of the gas bar business and a favorable 50 basis points from the impact of the consolidation of franchises. Food retail margin was approximately flat for the quarter, while drug retail was negatively impacted in part due to health care reform headwinds.

Retail SG&A as a percentage of sales is 21.1% or 110 basis points worse than the prior year. Our SG&A rate increased by 10 basis points year-over-year, after excluding an unfavorable 50 basis points from the impact of the gas bar business and 50 basis points from the impact of the consolidation of franchises. Against the headwinds, we were pleased with our ability to drive costs lower in the quarter.

On an adjusted basis, net earnings available to common shareholders were \$361 million, a decrease of \$5 million compared to last year. Normalized for the disposition of the gas bar business, net earnings grew by \$5 million. Adjusted earnings per share were \$0.94 in the quarter, representing a 3.3% year-over-year increase or an increase of 6.7% when normalized for the disposition of the gas bar business.

In the quarter, redemptions against the Loblaw Card program represented \$17 million. As this was part of our previous provision, the sales and corresponding profit did not benefit the company's financial performance. The first cards were mailed out during the last week of February and redemptions are averaging less than \$4 million per week.

Free cash flow was \$57 million in the quarter. We continue to return capital to our shareholders, buying back 8.1 million shares at a total cost of \$544 million. The buybacks in the quarter effectively fully utilized last year's normal course issuer bid.

Today, we announced a 9.3% increase to our quarterly dividend. This marks our seventh consecutive annual increase in the dividend rate on our common shares. Reflecting on our first of quarter 2018, we are pleased with our financial performance. The grocery marketplace continues to be very intense. While cost pressures continue, retailers are investing, lowering prices and increasing promotional intensity.

Despite this, we remain committed to our long-term financial framework and are continuing to focus on stable trading, promotional effectiveness, process improvements and efficiencies, while we invest for the future.

I will now turn the call over to Sarah to provide additional color on some of our key priorities.



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Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Thank you, Darren, and good morning, everyone. We are focused on 3 key areas in our core business. And effective January 1, we aligned our organization to support these priorities.

The first area of focus is to become a truly customer-centric organization, and Garry Senecal is our first management board member with a title of Chief Customer Officer. The second area of focus is process and efficiencies, and Rob Wiebe, our newly appointed CAO, is leading this initiative to take non-value-added costs out of our business. And the third area of focus is something we call data-driven insights. Galen touched on this on our last call, and I wanted to take a few minutes to provide you with a little more color.

Data-driven insights will provide a platform for us to better manage our pricing, promotion and assortment decisions to both improve the customer experience and our promotional effectiveness. This is about making decisions -- better decisions around what we put in front of our customers.

We have begun a journey to better use our incredible data set as a competitive advantage. We are not starting this journey from scratch. For years, Shoppers Drug Mart has developed and refined tools to improve its use of data and the Optimum loyalty program to optimize its return on promotional investment.

With the launch of PC Optimum and the introduction of new promotional tools in the food side of our business, we are now well positioned to excel in this area. Mike Motz, the former President of Shoppers, in his new role of Chief Operating Officer of our retail businesses, is leading this effort.

We began this phase of our journey towards the end of last year. We absolutely remain focused on stable trading, and we will be more scientific about how we balance growth and margin performance. For example, using our extensive base of customer insights and data, we are refining our item selection in our fliers to better optimize incrementality with the investment required.

Across our banners, we make thousands of promotional decisions every week. Improving these decisions will improve our overall basket profitability. We are pleased with the results we are seeing in the areas where we deploy this methodology in the quarter. The evolution of data-driven insights is a journey, and it will continue to be an area of investment and innovation for us going forward.

I would now like to turn the call over to Galen.

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

Thank you, Sarah. A passion for customers, data-driven insights and a relentless focus on process and efficiencies are 3 strategic areas where we are working to improve our core business. We are equally focused on our e-commerce strategy, what we call everyday digital retail.

Today, Loblaw operates the most extensive retail network for everyday needs in Canada. One of our stores is within 5 minutes of 90% of Canadians. Our objective is to deliver an equally seamless omni-channel experience across all our different businesses.

Joefresh.com provides stylish and affordable clothing for the active family. We continue to invest in our website and mobile experience to bring our customers more ways to shop Joe Fresh wherever they may be.

Shoppers Drug Mart is Canada's top beauty retailer, #1 in mass and prestige cosmetics and skin care. We are now ramping up that leadership online with e-commerce, home delivery and digital services integrated with beauty advisers in our stores.

And our digital pharmacy is now not only helping Canadians adhere to their prescriptions, it's assisting a growing segment of the Canadian population with a caregiver service, offering customers the ability to manage prescriptions on behalf of their family members.



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Each of these rapidly growing services is a demonstration of how our everyday retail strategy can bring simplicity and convenience to the often complex task of shopping and caring for yourself and your family.

Perhaps our most significant e-commerce initiative this year is the national rollout of our online grocery business. Today, our customers can order online and pick up their groceries within 2 hours, have their bags loaded into the trunk and be gone in minutes. Now branded as PC Express, we are adding 500 new pickup sites this year, including GO train commuter stations, many more of our supermarkets and the first of many expected Shoppers Drug Mart stores.

We also know customers want the option of home delivery when life demands it. Our partnership with Instacart, a Canadian first, brings our stores and our products to your door in as little as an hour. We already offer this service in 11 markets, with 5 more to follow this year.

We're now also seeing some very interesting indications of pickup and home delivery working together in a highly complementary manner. For example, one of our fastest-growing pickup locations now has a rapidly growing home delivery business. 4 months in, the 2 continue to grow in parallel, with absolutely no slippage in pickup orders.

As we add new PC Express sites by the hundreds and new home delivery markets by the dozens, we will blanket the country with an online grocery service in 2018.

Today, half of Torontonians are within 10 minutes of a PC Express site. That will grow to 90% by the end of this year, and 97% will have access to our home delivery option. Nationally, today, almost half of Canadians have access to PC Express or home delivery. And by year-end, 70% of Canadians will have the option to grocery shop with us in person, in their car or in the comfort of their own home.

Looking forward as the company faces continued competitive intensity and cost pressures, we remain committed to our strategy and optimistic about the opportunity to prosper in a dynamic world of omni-channel retailing.

Roy MacDonald

Thank you, Galen. And Tiffany, can I ask you set -- to set up the call for Q&A, please?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Irene Nattel with RBC Capital Markets.

Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

Just following up on Galen's last commentary around e-commerce. With this aggressive rollout across the country, how should we be thinking about your margin trajectory? And when you provided the guidance for essentially flat earnings this year, were you already taking that into account?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

So yes. The way to think about our investments and all our strategic initiatives is that they're planned, they're intentional, and they're designed to fit within our financial framework, and that is certainly the case this year.



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Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

That's very helpful. Looking at the Q1 performance, obviously, very nice same-store sales growth. And I know we can have a discussion about street math. But any way you slice it or dice it, it certainly looks as though you had a bit of wind in your sales. Can you talk about any changes that you might have made and how you went to market, whether what we're seeing is perhaps early results of some of the changes you're making around your promotional strategy? Really any color you can provide.

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

Yes. So I'll start, and then I'll turn it over to Sarah to provide a little bit of detail. Yes, there is street math. And I often comment it doesn't quite reflect a few -- the sort of the underlying performance. In this case, pretty much across all of our metrics in terms of share and tonnage and sales, we were pleased. It is a highly competitive market. Very, very intensive. And we are investing in, what we believe, is an intelligent way to try and keep pace.

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Okay. So I could just add on a little bit that, as you know, retailers are always looking at ways to improve the effectiveness of their promos. But what's new for us is we have better tools, and we have better data and we really are working on getting better analytical ability as well. And so with the loyalty program as well as the new promo tool that we're starting to roll out, we do have the ability to be just a little more effective in mixing back between -- in the flyer and what we're doing in loyalty offers, whether it's a mass offer or whether it's a customized specific offer. And that's really part of the program we've got. We started to roll it out in Q1 and more to come in the coming quarters.

Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

So though -- we should expect to see this, possibly even -- you sort of -- your use of it and more targeted and more effective promotions accelerate as we move through the year and into next year?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

That's the plan, yes.

Operator

Your next question comes from the line of Mark Petrie with CIBC.

Mark Robert Petrie - CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst

Darren, you highlighted, I think, flat gross margins, roughly for the food business but at the same time, alluded to additional investments in promotions and sort of heard that from competitors as well. So again, just sort of circling back to the discussion around gross margins, but could you just help us understand sort of some of the puts and takes on the food gross margin? And then I guess, in terms of these data-driven insights, was that already impactful in Q1? And how should we think about that playing out through the course of 2018?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Sure. Yes, as we look at the food trading margins, I mean, all in all, we were pleased with it being effectively a flat year-over-year, despite what we're seeing in terms of some inflating cost as well as increased promotional competitive intensity. So the way to think about it is we have seen benefits from our promotional effectiveness program. We've also seen some benefits from our supply chain handling fee, which are as well incorporated

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in that. So all in all, I think we're doing a nice job of balancing, given some of the headwinds that we're seeing in the marketplace today. And that's going to be our focus as we continue.

Sarah R. Davis - *Loblaw Companies Limited - President & Member of Management Board*

And I think, to the point of how much we saw in the first quarter, we did see the impact of some of the work we're doing. We'd estimate that we rolled it out in about 20% of the business so far.

Mark Robert Petrie - *CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst*

Okay. And I guess, just continuing on in the theme in terms of cost pressures but then offsets. It appears that you offset the impact from minimum wage through internal initiatives. Has that played out sort of as you expected? And what's your sense of the market in terms of how those higher operating costs through the industry could play out in terms of inflation rates?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes. So it has largely played out as we expected. So we're not seeing any surprises in our cost lines as a result of the minimum wage. We did a good job of predicting that. But the reality is that there are cost pressures almost everywhere. We see cost pressures in transportation. We see obviously the minimum wage pressure. And we're seeing increasing pressures from FX. What we're not seeing, given the competitive intensity in the market right now, is any indication of meaningful inflation.

Operator

Your next question comes from the line of Peter Sklar with BMO Capital Markets.

Peter Sklar - *BMO Capital Markets Equity Research - Analyst*

If you look at your -- the growth rate in your operating income in terms of your -- you're looking for a flat, really flat earnings this year, a flat operating income. But if you take out the effect of the minimum wage in the drug reform, you are looking for pretty substantial improvement in excess of line of what your -- in excess of what your top line growth rate is. So where is that growth coming from? I think you've talked about -- like the things I hear this morning are more effective promotions, the supplier [ask], headcount reduction. Are there any other significant items we should think about in terms of the context of your outlook?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes. So you're right to notice that there is significant underlying growth in -- that we're expecting in our core business P&L in 2018. However, it's not wildly different to the growth rate that you saw in 2017. And so what you should take away from that is that the underlying engine of the business continues to perform in line with our expectations. And it's really -- I hate to be boring, but it is all the same stuff. So we're aggressively looking at taking cost out. We did a significant amount of that in the lead up to the 2018 plan. And as we look forward in '18 and beyond, we know that we're going to continue to need to take cost out in other parts of the business, too, and the whole organization is mobilized around that. There aren't going to be any sort of one-hit wonders that are going to solve the problem in some kind of absolute sense. A huge portion of this is just getting better every day, simplifying the way we go to market, simplifying the thing -- the processes that we have inside the organization. And you should take some comfort from the fact that we have identified very specific streams where we think we can go and get that money. So in line with our historical growth rate over the last couple of years. And at this point, I think we can continue to sustain that.



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Peter Sklar - *BMO Capital Markets Equity Research - Analyst*

Okay. And then I just wanted to ask you a strategic question on e-commerce. Long term, I'd like to know how you feel about your competitive position versus the centralized fulfillment model. As you know, one competitor's going that way, Amazon may eventually go that way. And arguably, a centralized fulfillment model, if it's at capacity, has a lower cost, arguably could put through more capacity. I mean, you can only disrupt your store so much with picking. So I'd like to hear your thoughts about, long term, how your model will compete with the centralized fulfillment model?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes, I mean, it is interesting in Canada that the 3 traditional retailers have all taken a -- publicly, some quite different strategic approaches. Look, I think the message, from our perspective, we've been working on click-and-collect now for 3 years. We have -- we're very, very clear on the customer response. We're very clear on the investment that it takes to ramp it up, and we're very clear about the ongoing cost to operate it. And the customers are responding very positively to our offers, not just in the urban markets but also with a similar level of enthusiasm in some of the less dense rural markets. We also have an outlook in terms of what ultimately online grocery penetration is going to look like in Canada over the long term. And our view today is that leveraging the existing fixed cost infrastructure, that is our distribution system, which we believe is the most efficient national distribution supply chain in Canada, and a store network that maps -- blankets the entire country. This is an asset that can be leveraged in an extremely compelling way to support our ambitious e-commerce strategy. We have looked at the central fulfillment model. And it is another path, certainly, and we feel very confident in the path we are on. The thing is, none of us can really predict where things are going to end up. It's -- I think that's a little bit of a fool's errand. And so what we are intending to do is to create options and to focus on what the customer tells us they want. And what they want right now is they want grocery pickup, and they want access and availability to a very convenient, quick-serve home delivery. And with Instacart and our PC Express strategy, we're meeting that customer demand right now.

Operator

Your next question comes from the line of Patricia Baker with Scotiabank.

Patricia A. Baker - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Galen, you've telegraphed quite well, certainly, recently and on the last couple of calls, that accelerating digital was going to be a priority for you. We saw that today with the news on PC Express. I just want -- I'm a little bit puzzled, and I want some clarification here because, on the last quarter call, you indicated that you ended 2017 with about 300 click-and-collect sites across the country, that you were then going to be opening at a pace of 1 per day through 2018. And today, you're announcing adding 500 in 2018 to get to 700 by the end of the year. And so I'm missing 100-plus sites when I do the math there.

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

You are. I think I might have overstated slightly in Q4 the number that we already had in the market. So stick with the 700-plus number and the 500 that we're in the midst of rolling out this year.

Patricia A. Baker - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Okay. So now I know where they got lost. Interesting comment that you just made that I had not heard you say before. You said that you believe that Loblaw has the most efficient supply chain in the country. Is that -- can you give us a little bit more color on that? Is that primarily because of the fact that you've got so much more scale?



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Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes. Certainly, a fact of scale, it's also a fact that, over the last 7 or 8 years, we basically reengineered the entire supply chain from soup to nuts. And we have seen very significant benefits and reductions in cost and improvements in service as a result of that. And so we believe that we have a foundation with our supply chain that we can continue to invest in and build on that will be hard to compete with, both from a -- an e-commerce distribution perspective and also from a core grocery distribution perspective. And Canada is a big country. You have to have a lot of trucks running every day to effectively serve the populations in this country, and we do that very well.

Patricia A. Baker - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Okay. So that actually is a good segue into my next question: trucks, transportation cost. You indicated, like, the -- that the cost headwind from the myriad of factors in Q1 came in as expected and you managed them reasonably well. Pointed out that when it comes to the drug, generic drug impact, that will ramp up into the second quarter because that's when we really get the impact there. But also, is it fair to say that, on the minimum wage and related wage impacts and also maybe transportation costs, that the headwinds on costs will accelerate as we go through the year?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Certainly, the -- it's Darren here. Certainly, in terms of the health care reform, that one will increase in Q2. And right now, from a transport point of view, we are seeing increased costs there as well as some FX impacts in terms of our -- some of our prices. So we are seeing cost increase overall, but the minimum wage really was started in January.

Operator

Your next question comes from the line of Jim Durran with Barclays.

James Durran - *Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst*

I wonder if you could tell us what the shopping experience was on the gift card execution like? Were consumers coming in and getting the \$25 and leaving the building? Or are they spending it in your stores immediately? Were they buying more than \$25, like, how did that unfold?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes. So look, it's still very early. As we commented, we're seeing about \$4 million a week of impact from the Loblaw card. And so in simple terms, people are coming in, and they are spending in and around that amount. We can't see at this stage whether the redemption on the card is part of an incremental basket or whether it is a stand-alone transaction. Ultimately, we'll have to connect some dots in our database to have better visibility into that. So at this stage, we can't share much more clarity than that.

James Durran - *Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst*

So back to your comp store sales then, you would not have expected, given that there was only part of the quarter impact, that it might have had much impact on your comp store sales performance?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

No, it would be insignificant, I mean, with \$17 million in the quarter so a very small amount.



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James Durran - Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst

And on your e-commerce program, I don't know if you're able to, willing to provide us with some insight on how the consumer behavior is the same or different between what you see on click-and-collect versus what you might be seeing through Instacart? Are the basket sizes similar? Is the makeup of the baskets similar?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

Yes. So I think there's a few things that we can share, although it's important to call out that it is still early. So we are seeing bigger baskets in click-and-collect, smaller baskets, therefore, in Instacart. In both cases, we are seeing a high penetration of fresh, which I think is an indication that people are not intimidated by the notion of ordering fresh product through the Internet. But it also may be an indication that the average income of the early adopters in both click-and-collect and home delivery tend to be a little bit less price sensitive. I think we've commented that we see a slightly higher margin on our click-and-collect baskets. And so probably -- the hypothesis is that they are complementary because you have a customer looking for 1-hour convenient delivery because they're trying to fill in something that's in their kitchen, whereas the click-and-collect is more of the planned weekly shop. And that's why we believe there seems to be such a compelling room for both at the moment.

James Durran - Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst

And are you able to assess the reach? Like on a click-and-collect, is it largely customers within the same trading area as the store versus home delivery having greater reach?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

I think again, it's premature to comment. But the substantial click-and-collect customer comes from within a convenient radius to the pickup location. That's really the essential value proposition. It's reasonable to hypothesize that if somebody's got a store next to their work, that, that might also represent the most convenient pickup location for them. And you can see, by the partnership we announced with Metrolinx, we see pickup locations that are -- where people are, significant numbers of people are, at specific points in a day, will also be an area of focus for us. The idea is for these locations to be as convenient as possible. We will leverage our store network in order to achieve that. And we will also, like Metrolinx, look for specific places outside of our store network that are complementary as well.

James Durran - Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst

Last question on e-commerce. Just Shoppers Drug Marts are all -- I mean, you indicated that in the target of 700, there will be some Shoppers locations. Like are those locations limited to where you have the more expanded grocery offering? Are they wider than that? And how do you see the Shoppers piece playing out for you?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

Yes. I think the same answer to the first question. We're looking for ultra convenient pickup points for customers to pick up food. And whether it's Metrolinx and GO stations or whether it's Shoppers Drug Mart or perhaps others, this is what we're trying to do with the PC Express rollout.

James Durran - Barclays Bank PLC, Research Division - MD, Head of Canadian Equity Research & Senior Analyst

Would you foresee ever providing product to customers at the Shoppers Drug Mart location that it may not actually carry in store?



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Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes, that is the intent.

Operator

Your next question comes from the line of Vishal Shreedhar with National Bank.

Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Just on the impact of the CREIT-Choice deal on Loblaw's 2018 outlook, will consolidation impact the actual outlook? And does that -- does some of that consolidation flow through the minority interest line as well?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

In terms of the CREIT, we will be consolidating it, yes. And I would say that we still have things to work through as the transaction closes. But we would expect, call it, mid-single digits of EPS accretion as a result of the acquisition. And yes, there'll be impacts throughout the balance sheet and minority line items. So we'll work through that as the deal closes.

Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Okay. So we'll, in fact, go through the minority line item?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Again, we have to look at all the details, and we'll get back to you on that.

Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Okay. Moving on here, just in terms of retail performance in the quarter, sales were really good across both segments. But the gross margin delevered a little bit here, excluding the adjustments that you guys noted. And I think you alluded to this. But wondering if, in your estimation, you hit the right promo sales kind of balance in the quarter. And maybe if some of the sales that you got in your comps weren't as productive as management would've liked?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

So I'll take that. We're working hard to get more effective, as Sarah mentioned. And we are happy with the places where we deployed the promo effectiveness tool. And yes, there were probably some places where we invested a little bit more than we expected. But in the stable trading range that we so often talk about, we were more pleased than anything with the way that the business managed the trade-offs between sales and margin.

Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Okay. What does stable trading range mean? Could you give us a range? Is that 20-plus, minus or 100-plus, minus?



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Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

So yes. So I mean -- so what is stable trading? Stable trading is that we want to run consistent performance day in and day out. We think about that in terms of sales, its relationship to internal inflation and then our market share versus the rest of the market. And I think I mentioned on Q4 that we're sort of widening the band in stable trading as we deploy these promotional effectiveness tools, just to give the organization a little bit more freedom and flexibility. So you may see volatility in the margin and the sales in coming quarters. Our expectation is to manage it within a reasonable range, and we believe we did so in Q1.

Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

Okay, so moving on. And net earnings growth, in the quarter, it was roughly flat, largely consistent with your yearly 2018 guidance. But major drug reforms will start to -- they'll magnify in Q2, as you noted. And so I'm wondering, if there are new efficiency initiatives that kick in, in Q2 to help you achieve this kind of similar cadence on net income, x the Choice-CREIT consolidation that will come in to help us fill that gap, so your sales are solid but your net income is flat and your challenges will magnify?

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

Okay, it's Sarah. I'll take that. So yes, we are constantly looking at ways to take non-value-add costs out of our business. And we have a number of initiatives that will start to come in at different times. So as we mentioned, we did do some -- announced a few things in Q4 that we were doing. But as far as oncoming cost, there's a few specific examples I could give you. So number one would be the rollout of self-scan at Shoppers. You would have seen this in a few stores at the end of last year. We're now at about 260 stores, and we're planning to move that to around 400 by the end of the year. And what we are seeing is that the penetration of self-scanning is starting to increase. We thought it would come in at around 15%, and we have many stores that is closer to 25%. So much more productive than even we had predicted. And I would say the benefit is also that it's actually improving customer satisfaction. It really is allowing people with small orders to get in and out of the stores more quickly. Another example of what we're doing is we've been working on reducing the amount of inventory we carry over the last few years. We worked on it in our DCs. We've also -- working on it in our stores. We've actually decreased our inventory by about 16% in our DCs and 19% in our stores over the last 3 years. And with less inventory, there's less handling of the inventory. And with less handling of the inventory, there's less labor required to handle the inventory. So in some parts of our business, in our retail network, we're down from touching the inventory 4x down to 2.5x. So this allows the store to be more productive and have less labor. So it's also improved the availability in the store, and it's improved our customer satisfaction and colleague engagement as well. So it really is a win-win as we're becoming more effective in our end-to-end process from our suppliers right through to our stores. And then another example, we have many of these, but another one would be the use of centralized sales in -- for shared services at Shoppers. So basically, it's centralizing the pharmacy prescription. It improves the cost of fill at the store, so you don't need to have the same amount of pharmacy hours in the store if you're doing it centrally. It allows -- it frees up time for the pharmacists as well, so the pharmacist can spend more time on dealing with the customers, which is obviously part of our customer centricity, and also being able to offer them new services in the pharmacy as well, whether it's flu shots or any of the other additional services we can -- so those are just 3 examples. But there's many -- every part of our business is looking at ways to improve their productivity and to reduce their costs.

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

And Vishal, I would just add to that. Although we're not giving guidance for Q2, we're still very comfortable with the annual guidance of essentially flat adjusted earnings.

Vishal Shreedhar - National Bank Financial, Inc., Research Division - Analyst

Okay. That was very helpful. And just a quick and easy one here. On your balance sheet, when you -- and as Darren noted when you consolidate, I think your debt metrics will increase. Is there a threshold that investors should look at through tolerance, what debt levels you want to go to when you buy back stock (inaudible)?



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Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

I mean, we were focused on maintaining our investment grade with all our debt. And so we look at it through each piece. We look at it on the retail side at PC Financial and as well with Choice. So we feel quite comfortable with our balance sheet today and continue to have some excess cash in addition to that. So all in all, we're very comfortable where we're at.

Vishal Shreedhar - *National Bank Financial, Inc., Research Division - Analyst*

Okay. So should I use the 4x number within the rating that DBR has issued as a threshold or something lower than that? Or is there any help you could give us, just trying to model the buybacks here?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Well, I think you have to look at it again by each. And for where we are today, I mean, not really -- as you start looking at higher multiples, it would include us doing some merger, acquisition or something, which we don't have currently any plans to do. So from a higher end, you really got to look at each business. Not going to provide that number today, though.

Operator

Your next question comes from the line of Michael Van Aelst with TD Securities.

Michael Van Aelst - *TD Securities Equity Research - Research Analyst*

I'll just start by following up on that. On the NCIB, would you expect to continue to exercise it on a -- at the same pace as we've seen in the last year with the growth, free cash flow. How do you look at it?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

Yes. I mean, we were clearly aggressive in Q1 taking advantage of our strong cash flow or strong cash position at the end of last year and completing last year's normal course issuer bid. So as we mentioned on the last call, you should expect us to put a significant amount of free cash flow to buyback and think about buybacks for this year in a similar range to 2017. So what that means is don't expect the level that we did in Q1 each quarter of this year.

Michael Van Aelst - *TD Securities Equity Research - Research Analyst*

Okay. And then if you look at the -- at your traffic, I don't recall when the last time was that you had traffic increase, but I know you didn't have it the last couple of quarters. So what do you think has changed the trend on your traffic? Is that something where you're seeing more industry-wide traffic coming into the -- into stores? Or is it tied to some of the PC Optimum changes that you've made? What would you attribute it to?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

I don't think there are any meaningful changes, meaningful sort of new drivers that change the trend. It -- we feel we've been operating pretty consistently, again within that range in terms of sales, traffic and share and the like for the last number of quarters. And this is on a slightly better side. Last quarter, it was on the slightly worse side. Look, we're getting better at the things that we're doing, and we're hopeful that those are



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showing up in the minds of the customers and improving traffic. But it's all really around the edges at this point as opposed to some kind of fundamental shift.

Michael Van Aelst - TD Securities Equity Research - Research Analyst

Okay. And just finally, on the inflation, you said that you're not seeing any meaningful inflation. We saw it somewhere, CPI 1.2 in the quarter. But it did -- does seem to be easing up a little bit. Is that a sign of the competitive pressure intensifying? Or is there -- or are there other commodities that are affecting that?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

So when you say easing up, you mean inflation seems to be getting softer, or is it getting better?

Michael Van Aelst - TD Securities Equity Research - Research Analyst

It's getting a little slower inflation as the months go on.

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

Yes. Look, I think this is just -- we've talked a lot about this, over the last 4 or 5 quarters, that the competitive intensity in the market is very significant. And that we, from our perspective, didn't see a -- sort of a -- an increase in inflation that would be in line with what the industry saw 2 years ago. But we are pleased that it's moved from negative to positive. And I think that we're right now running at a level that is quite sensible. What makes it particularly difficult is that the cost pressures are significant and they continue to grow. And so being good at efficiency in terms of your promotions and being relentless in terms of taking bad costs out of the business is something that one needs to do in order to prosper in the current environment.

Operator

Your next question comes from the line of Keith Howlett with Desjardins Securities.

Keith Howlett - Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst

I had a question about the PC Optimum program. Can you speak to how the integration process went and how many active members you now have relative to the prior period?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

So yes. So very pleased is the short answer on PC Optimum. And probably, the best metric to think about in terms of where we sit with the program today is that we have now reached the previous scan levels in both Shoppers Drug Mart and across the food business. So the levels that people were scanning cards through the tilt before we combined the program. And even more optimistically, that rate looks like it's continuing to grow. We did have a few challenges from a technology conversion perspective in the last 2 months, and we're pleased to report that those are all behind us. And so we're looking forward over the next few months to optimize the PC Optimum program and make sure that we realize the strategic potential of that investment.



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Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

And tied to the PC Optimum, do you anticipate a more aggressive move to increase consumer balances on your MasterCard? Or are you sort of happy with the level of sort of accounts receivable?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

We're pretty happy with the way that the credit card and President's Choice Financial is being managed. I think the focus that the team is working on now is moving past the core banking relationship with the CIBC. I'd say the way to think about the relationship between President's Choice Financial and PC Optimum is that as more people get engaged in the collective program of PC Optimum, we think there may be an opportunity to convince them that trading up to the MasterCard and turbocharging the amount of points that they can earn will actually be a terrific choice for them. This is a no-fee card, do a little selling at the moment, across all aspects of that portfolio. So if you're a loyal Shoppers customer or a loyal Loblaw customer, you really should have the President's Choice MasterCard. It's worth your while.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

And just on the Shoppers Drug Mart, are they -- what is the timeline on the SAP implementation there?

Darren G. Myers - *Loblaw Companies Limited - CFO & Member of Management Board*

That's a multiyear journey. And it's not definitive in terms of the stores. But we are starting with rolling out within some of the distribution centers, and we're just doing it thoughtfully as we go through it.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

And then just had a question on the pickup points for the click-and-collect PC Express. When you put it at a Metrolinx station, do you have 3-temperature holding area or...

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes, we do. And let me take this -- take a moment just to clarify an earlier question. So when we talk about rolling out a location at Shoppers Drug Mart, it's a PC Express location, which is essentially an opportunity to go on to one of our food websites to order groceries and pick them up in Shoppers. We're not providing the Shoppers Drug Mart assortment for sale online through PC Express at this point. In terms of temperature control, yes, at Metrolinx, we have -- we're trying out multiple examples of pickup. We have a -- pickup lockers, we have pickup vans, depending on the number of people and depending on the locations on the GO train. And we'll work through, ultimately, what the most effective and customer-centric versions of that are. But each of them has what you would expect in terms of appropriate temperature control.

Keith Howlett - *Desjardins Securities Inc., Research Division - VP, Consumer Products & Merchandising Analyst and Retail Analyst*

I had just one last question on your format strategy going forward. Over the last 5 years, you've introduced the City Market in the West, and I guess, more Your Independent Grocers and I guess, No Frills in Atlantic and the West. I'm just wondering, in terms of reception of your banners, whether they've been this enthusiastically received, I guess I would cite Ontario as they are received here.

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes. So the way we think about our format is that we have essentially 2 formats in each of the food divisions. We have a hard discount format and a superstore format in the discount division, and we have a -- an Inspire format and a Neighbour format inside our market division. And as far as



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the Inspire stores and the Neighbour stores, they can scale up or down in terms of size. I think the question you're asking is, are our smaller urban stores in Western Canada, which are generally Your Independent Grocers, will be happy with the way they are performing, and the answer is yes.

Operator

Your next question comes from the line of Chris Li from Macquarie.

Christopher Li - *Macquarie Research - Research Analyst*

Thanks again for the clarification on the Shoppers' food pickup. Just a quick follow-up on that is, from the associate owner perspective at Shoppers, is it fair to assume this is going to be a net benefit for them in terms of hoping to generate some incremental traffic to the stores as people come and pick up their food?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Yes, I think it's fair to anticipate that. Remember, look, we're announcing, one, and we're suggesting that there could be an exciting strategic opportunity here, but it is still very early days.

Christopher Li - *Macquarie Research - Research Analyst*

Okay. And then one of your competitors recently mentioned that they're seeing relatively better performance to the conventional stores over discount, partly because of low inflation and a relatively strong consumer. Curious to see if Loblaw is seeing a similar trend as well.

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

Well, we see -- we've been seeing pretty strong performance in our discount business. And we've also been pretty happy with the performance in the market division. For at least 15, 20 years, there has been a gradual shift away from the conventional market stores towards discount. We don't see a reversal of that trend at this point.

Christopher Li - *Macquarie Research - Research Analyst*

Would you say the shift has kind of slowed down a little bit versus, say, a few years ago?

Galen G. Weston - *Loblaw Companies Limited - Chairman, CEO & Member of Management Board*

I don't think so. It's very hard to tell, given that so much of this is influenced by store banner conversions and site closures. So -- but I wouldn't -- we would not call out a meaningful change in that trend.

Christopher Li - *Macquarie Research - Research Analyst*

Okay. And maybe one for Sarah, you mentioned about the self-scan rate at Shoppers. Just curious to see, for stores that have self-scan and they're -- are at, say, 25% penetration, what's been the corresponding net reduction in store labor expenses that you've seen at those stores?



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Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

I don't have the specific numbers of the percentage, and I don't know that I would share with you anyways. So we would just say that, obviously, we went to the stores where they had a higher labor percentage and went to those where you would get the biggest bang for the investment in the self-scanners, that's where we've gone. So those would be the ones we've covered first, seeing the best return there, and then we'll move out to the other ones now that we've seen how well those have performed, but I don't have the specifics on the exact dollar savings or percentage of labor savings in the stores.

Christopher Li - Macquarie Research - Research Analyst

Okay. And would you say -- would there be a similar opportunity at the grocery stores? Or is it more difficult just because the nature of the products that are being sold...

Sarah R. Davis - Loblaw Companies Limited - President & Member of Management Board

No, I would say we're definitely -- we've always -- we've done self-scan in the grocery food business for a long time. So we are looking at the different new models. Our technology, some of them have been out there for a long time, over 10 years. So we're definitely looking at new technology that could make the self-scans more customer friendly in a lot of cases, more effective, more productive, smaller so they don't take up as much space. So we're definitely looking at improvements to self-scanning in the food stores as well.

Christopher Li - Macquarie Research - Research Analyst

Okay. And then last one for Darren, just your transportation costs. Are they generally expensed in your cost of goods sold or SG&A expense?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

They were in SG&A.

Christopher Li - Macquarie Research - Research Analyst

And just...

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

Sorry, sorry, they're in our gross profit, pardon me for that.

Christopher Li - Macquarie Research - Research Analyst

In the gross profit. And just in the [piece] that are at risk in terms of the pressure from the states, can you just help us understand a little bit, like, what percentage of your COGS would that be roughly?

Darren G. Myers - Loblaw Companies Limited - CFO & Member of Management Board

I think it's -- overall, the -- in terms of the increases, it's quite small, but it just adds up in terms of the costs that we're dealing with. So it's just one of the impacts that we're dealing with right now.



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Operator

Your last question comes from the line of Irene Nattel with RBC Capital Markets.

Irene Ora Nattel - RBC Capital Markets, LLC, Research Division - MD of Global Equity Research

Just another question, if I might, on PC Optimum. Clearly, you're getting some very nice response from consumers. We've seen a couple of external merchant partners or the earn elsewhere, burn within your banners. Should we be sort of expecting to see more of those partnerships? Or really, are you going to keep -- try and keep it sort of within the family, so to speak?

Galen G. Weston - Loblaw Companies Limited - Chairman, CEO & Member of Management Board

Well, listen -- thank you for that question. It does give us an opportunity to talk about how pleased we are with the Esso partnership announcement that we made earlier in March. It's worth remembering that we have had a relationship with Esso through President's Choice Financial for a number of years now. So we have a very, very good visibility into the complementary relationship between everyday consumable purchases and drug and food and then the everyday consumable purchase of gas. So there's a very complementary relationship there, and we're really excited about bringing that to Esso stations and making Esso stations available as a place to earn points for our PC Optimum customers. Our focus right now -- I mean, look, we've just -- we're just a couple of months into launching this harmonized PC Optimum program. The principal focus here is to optimize what we have and make sure that we are giving the customers everything that they expect from that program inside the operations and the partnerships that we have. If we were to consider any more external partners, we would do so very carefully, with an eye to making sure that they were complementary to our core customers' everyday needs expectation.

Operator

I will now turn the conference back over to our presenters.

Roy MacDonald

Great. Thanks very much. Thank you, everybody, for your time this morning. If you have any follow-up questions, you know where to find me. And please mark your calendars to join us on July 25 to discuss our Q2 results. Thank you, and have a great day.

Operator

This concludes today's conference call. You may now disconnect.

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